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INTELLIGENCE MEMORANDUM NO. 264

**SUBJECT: Estimated Consequences of Possible US Courses of Economic
Action with Respect to China**

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ESTIMATED CONSEQUENCES OF POSSIBLE US COURSES OF ECONOMIC ACTION WITH RESPECT TO CHINA

SUMMARY

Although China is basically agricultural and relatively self-sufficient, the commercial and industrial economy of the urban areas is responsive to external economic influences. In addition, the ambitious program for economic development which the Communists hope to launch in the near future will make them vulnerable to measures which would deny access to essential items of both a continuing and a non-recurring nature.

Assuming that ultimate US objectives with respect to China must involve either a degree of economic coercion inhibiting China's ability to reconstruct and develop its economy; or a course of action aimed ultimately at alignment of China as a Western ally, certain courses of action might be applicable. On the side of coercion, the most feasible and effective would probably be a system of export controls which would primarily represent an extension of the system now employed to retard development of the Soviet war potential. Thus controls would become applicable to China, as a presumptive ally of the USSR to the extent that China would (a) itself be strengthened as a Soviet ally, and (b) be in position to transship strategic materials to the USSR. Hence, the present restrictions placed upon the USSR and its European satellites would generally apply to China, plus a restriction against such commodities as cotton and petroleum which are important, continuing requirements of China's urban economies. The effectiveness of such controls would be in large measure dependent on the cooperation of other non-Communist nations in observing them. To the extent that they allowed commodities and services restricted by the US to be made available to China, the US might derive none of the benefits but all of the disadvantages inherent in a restrictive economic policy.

Certain other methods primarily aimed at coercion, such as an embargo, discouragement of American-flag shipping and US airline contacts with China, or withdrawal of US citizens, present difficulties which make them seem impractical in application to the problem.

Actions primarily aimed at the eventual alignment of China as a Western ally would, to a considerable extent, be the reverse of those discussed above. On the theory, for example, that ultimate Sino-US friendship and the ultimate economic dependence of China on the US would best be encouraged through uninhibited trade, restrictions might be relaxed, and goods not of immediate strategic importance to the USSR might be freely sent to China. Such a policy,

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however, would not necessarily be recognized by the Chinese as a gesture of friendship, because the US action would be interpreted as inspired only by profits to be derived from the China trade. Nonetheless, since in time China will be greatly in need of foreign capital, eventual extension of US assistance in the form of public or private credit might be of some effect in securing Communist acquiescence in Western objectives.

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~~CONFIDENTIAL~~2. General Considerations.

Any economic moves directed by the US against Communist China would presumably be part of the general US effort to restrict the war-making potential of the USSR. In the foreseeable future, however, China's economic role in adding to Soviet strength would be limited to such strategic materials as it could itself furnish to the USSR, and those that it could obtain elsewhere for transshipment to Soviet-dominated areas. In determining the consequences of any particular modes of action that might be adopted with respect to Communist China, a major consideration is the extent of cooperation with the US that can be expected from alternative non-Communist sources of supply for essential goods, services, and credit. Such cooperation would probably be hard to gain, especially from such neighboring Asiatic powers as India whose attitude toward the new Chinese government does not necessarily parallel that of the US, and possibly from the UK whose desire for trade with the new China has been manifested on several occasions. To the extent that these or other non-Communist countries might supply commodities and services that China would otherwise obtain from the US, the United States might reap all the disadvantages of a restrictive policy and obtain none of the advantages. China can, of course, obtain needed materials from the USSR and the Soviet group, but not, as of present writing, in adequate quantity or quality to meet most of China's requirements.

A further consideration in determining the consequences of particular actions in the field of trade and commerce results from the distinction between the economic needs of agrarian and urban China. Agrarian China, self-sufficient at a low level of economic activity, will be comparatively little affected by external economic influences that might be brought to bear by the Western Powers. Since agriculture is the basis of the country's economy, the Chinese Communists can probably survive the extended application of external economic pressures.

The commercial and industrial economy of the cities, however, is responsive to external economic influences, while the avowed interests of the Communists in promoting economic development render them vulnerable to measures which might deny access to pressing industrial requirements. Railroad rolling stock, motor vehicles, mining machinery, electric power generators, and other

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industrial equipment will be urgently needed. Even more important, because they constitute non-deferable requirements, are such items as petroleum and raw cotton, which must be imported on a continuing basis to maintain industrial activity and employment in the cities. The political support of the industrial proletariat in the key port cities of China depends in large part on Communist success in obtaining these essential imports.

When the Chinese Communists embark in fact as well as in propaganda on an ambitious program of economic development (sometime after 1952), China will be faced with increasing requirements for key industrial equipment and substantial foreign capital and will thus become more vulnerable to external economic pressures.

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2. Possible US Courses of Action.

It is assumed that US economic courses of action taken with respect to China will be aimed either at impeding the progress of the Chinese Communist regime or at ultimately aligning it with the Western Powers. Often, however, actions aimed at either objective may prove to be basically similar, with their effect in one direction or the other dependent only on a change of emphasis. Thus, a flexible program of export controls could be aimed, on the one hand, at inhibiting, or on the other at permitting progress toward the reconstruction and development of China's economy. Further a course of action designed to impair the Chinese economy could, in the event of China's disillusionment with the USSR, by forcing China into complete economic dependence on the USSR, result in effective reorientation.

a. Actions Aimed at Impeding the Progress of the Chinese Communist Regime.

In considering each of the following possible courses of action, the economic and political consequences of the action will be discussed first and the problem of feasibility last.

(1) Complete Embargo of US Trade with China.

(a) Economic consequences. In the postwar period, about half of China's import trade and more than one-fifth of its export trade has been with the US.^{1/} A complete embargo of US trade with China, therefore, would be at least partially damaging to China's efforts at economic reconstruction.

(b) Political consequences. In the short run, the major political consequences of a complete embargo would be to reinforce Communist China's pro-Soviet orientation. In addition, such an action would lend substance to the Chinese Communist charge that the US is the "bitter enemy of the Chinese people."

(c) Feasibility. Domestically, such an embargo could be authorized by act of Congress or by Executive Orders which would cover such fields as fund-freezing and the halting of exports through a tight administration of export controls. Since China trade constitutes only some 2 percent of total US foreign commerce, the action would not be seriously damaging to the domestic economy. To be effective, however, such an embargo would require active cooperation on the part of other non-Communist nations which are alternative suppliers to and buyers from the Chinese market. It is estimated (see (3) below) that such cooperation

^{1/} In the period prior to World War II, by comparison, the US supplied approximately one-fifth of China's imports and took one-fourth of its exports. This was a proportion higher than that of any other single country

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would probably be limited to trade in war materials. Last, a complete embargo is an action of greater severity than any presently applied by the US to the USSR and a step that is usually resorted to only in a situation just short of war.

(2) Application of Export Controls on US Shipments to China.

(a) Economic consequences. Export controls would be most effective in relation to those commodities for which the US and US-occupied areas are principal sources of supply.

Goods now subject to export controls include many items of machinery and equipment which the Communists might require for economic reconstruction and development. In terms of current Chinese needs, controls over non-recurring items of industrial equipment would be at least as effective as those commodities needed to satisfy non-deferable continuing industrial requirements, such as cotton and petroleum.

The Chinese Communists' most important non-deferable industrial requirement in 1950 will be raw cotton. To maintain even half-capacity operation of the coastal cotton mills, China will have to import over a half-million bales of cotton in 1950. Interdiction of China's foreign sources of raw cotton would cut deeply into the operation of China's most important manufacturing industry and present the Communists with a major unemployment problem in key urban areas. Since the other cotton-exporting countries of the world have generally committed most of their surpluses for 1950, China's prospects for importing cotton, except from the US, are limited.

The interdiction of China's supply of petroleum would significantly reduce the current operating capacity of that country's industry and transportation. Although petroleum is not a "high strategic" (1-A) item, effective cooperation on petroleum shipments can be expected from other major non-Communist sources.

(b) Political consequences. A tight US export control program, supported by other non-Communist powers, would compel China to seek the machinery and equipment required for economic reconstruction and development from the Soviet bloc. Over the long run, such controls might serve to impair Sino-Soviet relations, as the Chinese became increasingly dissillusioned over the quality and quantity of imports from the USSR.^{2/}

^{2/} There are indications that the Chinese are already dissatisfied with Soviet deliveries of gasoline and machinery.

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Within China, the major political consequence probably would be to increase the urban population's dissatisfaction with the Communist regime. Some of the early enthusiasm for the "liberators" of Shanghai is already being dampened as interdiction of imports by the Nationalist blockade brings unemployment to many workers and difficult labor and production problems to Chinese, as well as foreign, businessmen. Export controls, particularly directed at such non-deferable items as cotton, would prolong unsatisfactory economic conditions in urban areas.

Although an export control program, like a trade embargo, would make the Communists' anti-US propaganda more convincing, a control program would permit a better US counter-propaganda case. On the strength of the Communists' own claims, the US would be treating the Chinese Communist regime as a member of the Soviet bloc, and any responsibility for US export controls on shipments to China would therefore devolve on the Chinese Government.

(c) Feasibility. The experience and administrative organization developed by the US in licensing exports to the USSR and to satellite countries would facilitate the task of organizing an export control program directed at Communist China. Although prior decisions are required regarding the number of items to be licensed and the quantities of selected commodities to be permitted for "normal" or "minimum" civilian requirements, no difficulty is anticipated which could seriously impair the administrative feasibility of an export control program. In embarking on such a program, however, the US could expect maximum effect only to the extent that other countries would not agree to meet China's requirements. The cooperation of other major Western nations could probably be obtained in controlling shipments of highly strategic goods to China.

(3) Inauguration of Positive Action to Obtain the Cooperation of Other Non-Communist Nations in the Implementation of Economic Sanctions Against China.

(a) Economic consequences. Cooperation on the part of other non-Communist nations in the interdiction of goods and services needed by the Chinese Communists for reconstruction and development which are not available from the Soviet bloc would seriously inhibit both China's economic recovery and its progress toward industrialization.

(b) Political consequences. As in the cases of US embargo or export control, such cooperation would reinforce Communist China's pro-Soviet orientation. Further, such cooperation would be represented in Communist propaganda charges as an alliance of the entire "imperialist" world in an anti-Chinese bloc.

(c) Feasibility. It is apparent, on the basis of US experience thus far, that voluntary and vigorous cooperation on the part of non-Communist nations in the implementation of tight controls over goods,

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services, or credit for China will probably be difficult if not impossible to obtain. The US might exert political or economic pressure to force "cooperation." However, if such cooperation were inconsistent with the self-interests of these countries, US security objectives of at least equal importance elsewhere in the world, would probably be jeopardized.

(4) Discourage American Flag Shipping from Calling at Chinese Ports.

(a) Economic consequences. Since essential imports into China are not dependent upon the availability of American-flag vessels, the economic effect on China of an embargo on US shipping would be negligible. ^{2/}

To be effective, therefore, a shipping embargo would require the cooperation of other maritime nations.

(b) Political consequences. A US shipping embargo would deprive the US of whatever prestige might accrue from US vessels appearing in Chinese ports and would furnish the Communist regime with a propaganda weapon for the intensification of anti-US sentiments. Since a US embargo would have little positive effect on China's trading position and an effective embargo would require active cooperation by other maritime powers, a direct consequence of this course of action might be discrimination against US shipping interests.

(c) Feasibility. A US shipping embargo against China, while administratively possible, would be logically undertaken as part of a general US trade embargo (see "1" above) and the feasibility of such a course of action is dictated by the same considerations which apply to the feasibility of that course of action.

(5) Discourage US Airline Contacts with China.

(a) Economic consequences. Two types of airline operations are relevant to this discussion: (1) US international airlines, such as Northwest and Pan American, and (2) US private interests in Chinese domestic airways. US restrictions on international airline service to China would have negligible economic consequences for the Chinese Communists. China's limited requirements for such international transportation facilities could largely be met by Soviet bloc and non-Communist airlines. Among the latter are British Commonwealth, French, Dutch, Philippine, and Norwegian airline services in the Far East.

While the Chinese Communist regime undoubtedly would benefit by having additional domestic air transport facilities, it is estimated that the equipment and trained personnel now available are adequate to meet present Chinese requirements.

^{2/} Although one-third of the tonnage entering and clearing the port of Shanghai in 1948 was of US registry, a sizeable proportion of the freight carried by these ships was ECA cargo.

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(b) Political consequences. The political and, in this case, military consequences of US discouragement of airline negotiations with Communist China are more significant in terms of US security interests than are the economic consequences. Militarily, failure to discourage US airline activities could mean an addition to the Chinese Communist air potential, as a result of US assistance in maintaining air and communication facilities and the training of air and ground personnel. Politically, however, it could be to the ultimate disadvantage of the US if the whole organization of Chinese airways were left to Soviet or other exploitation -- a development which would be the probable consequence of official discouragement of US aviation interests in negotiations with Communist China.

(c) Feasibility. The US has direct control over US international airlines and there would thus be no problem in preventing US airline service to China. Although the US has no direct control over US interests in Chinese domestic airways, the US might (1) prevent, by immediate presumptive action, additional Chinese aircraft of partial US ownership from defecting to the Communist regime, and (2) hinder, through export controls, the extensive development of Chinese domestic aviation.

(6) Withhold All Credits, Official and Private, from China.

(a) Economic consequences. The economic consequences of denying US credits to China would be slight during 1950. The demand for short-term credits in the immediate future will not be large and can be met by the Soviet bloc or non-Communist countries. Nevertheless, limiting China's access to dollar exchange might have some unfavorable effect on China's commerce by directing it toward relatively disadvantageous trade by barter. China's industries, primarily the textile industry, whose operations depend on imports of raw materials, would also suffer from a lack of dollar exchange.

China will not need long-term credits in substantial amounts until the Communists are prepared to embark on their planned economic development program, scheduled to begin in 1952. China's requirements for credits at that time probably will be greater than the Soviet bloc will be able or willing to meet, and this fact could enhance the bargaining position of the US.

(b) Political consequences. The refusal of US businessmen and banks to arrange short-term loans to finance imports into China may aggravate Sino-US relations, and result in the further withdrawal of US interests from China. Further, the Chinese Communists could be expected to claim that US action in withholding import-financing credits was the reason for internal economic distress. The political consequences of withholding US official and private long-term credits to China would probably be small, since the possibility for such credit has already been publicly discounted by the Communists.

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(c) Feasibility. The US is in no way committed to extend credits to Communist China, and the Communist regime has stated that it does not, and cannot, expect credits from the US. It is clear that the US need take no action to discourage long-term private credits and investments in China at this time, since private investments will not be made under existing political and economic conditions. It may be somewhat difficult, but still feasible, however, to prevent the Chinese Communists from receiving certain short-term credits, especially those customarily granted in trade transactions, since the continued operation of US firms and banks in China may depend on their ability to finance imports on behalf of the Communist Government. A US policy of withholding long-term credits in the future, however, would not significantly inhibit China's economic development unless the cooperation of such possible alternative sources of credit as the UK, Belgium, and Switzerland could be secured.

(7) Encourage All US Citizens to Withdraw from China.

(a) Economic consequences. Even if the US could successfully withdraw all Americans from China, the economic consequences to the Chinese Communists would be slight. Only in exceptional cases would it be impossible to replace US citizens' professional and managerial services with those of other nationalities.

(b) Political consequences. The withdrawal of US citizens from China would deprive the US of a means for the possible counteraction of anti-US propaganda and a means of preserving US prestige. The refusal or reluctance of many US citizens to leave China despite official US pressures would, of course, diminish the prestige of the US Government and would be exploited by Chinese propaganda.

* (c) Feasibility. The only means at the disposal of the US Government for reducing the number of private Americans in China are (1) official requests that US citizens leave, and (2) refusal to provide passports valid for China. Thus far, official requests have had little effect, as evidenced by the relatively few Americans who took advantage of special evacuation facilities provided in September 1949. By requiring all foreigners to have "Exit Permits" before leaving China, moreover, Communists could exert considerable pressure to prevent the departure of any American performing a function useful to the regime. Although US refusal to issue passports valid for China would have little immediate effect, this appears to be the only official action the US could take to reduce the number of Americans in China over the long run.

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b. Actions Taken to Align the Chinese Communist Regime with the Western Powers.

(1) Encouragement of Trade with China.

(a) Economic consequences. The effectiveness of US export controls over some non-deferable commodities required by the Chinese industrial economy may diminish with the passage of time.^{4/} Thus, bargaining power accruing to the US through such export controls may prove of limited duration. The US, nonetheless, might maintain considerable leverage by offering to relax controls on such non-recurring items as steel rails, locomotives, railway bridging, coal-mining machinery, power-generating units, and repair-shop equipment on a quid pro quo basis, since these items would contribute significantly to the Communist program of economic development.

In conjunction with a policy of relaxing export controls, the US could adopt parallel measures to allow an expansion of Japan's trade with China, which, because of the complementary character of the Chinese and Japanese economies, would offer impressive economic advantages to the Chinese Communists as well as to the Japanese.^{5/}

(b) Political consequences. Relaxation of US export controls would prove ineffectual as a means of realigning the Chinese Communists at present, since Communist propaganda holds that US capitalists have an overriding interest in amassing profits by maintaining the China trade. This view that the US is more interested in commerce between the two countries than is China, would be reinforced by any hasty US encouragement of trade.

If the relaxation of trade controls can be at all effective in realigning the Chinese Communists, it will only be after a demonstration that the US is not compelled to trade with China in order to preserve "American profits." When the Chinese Communists become disillusioned with deliveries from Soviet sources, the relaxation of US controls may be more readily accepted as a token of friendship for the Chinese people rather than as a manifestation of US "profiteering."

(c) Feasibility. No serious administrative difficulties would render measures to encourage trade with China unfeasible. Since such a program could be implemented by a more liberal review of applications for export licenses rather than by the complete abolition of export controls, the new policy, by and large, would require continuation of already existing procedures and the present careful scrutiny of such important determinants as the "end-use" of items destined for export to China.

^{4/} With reference to raw cotton, for example, future Chinese cotton harvests may prove more favorable than the harvest of 1949.

^{5/} The Japanese market represents the only feasible and significant outlet for such Chinese exports as coal, salt, and iron ore. In addition, China must look to Japan as the cheapest source of a large proportion of its manufactured imports.

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(2) Encouragement of American Flag Shipping Contacts with Communist China.

(a) Economic consequences. Opportunities extended to the Communists for expanding their trade with the US, rather than the services of American-flag vessels per se probably would prove of greater significance in US efforts to realign the Chinese Communists with the West.

(b) Political consequences. The movement of American-flag vessels in and out of Chinese harbors would provide an important contact with the Communist regime and would effectively advertise Sino-US trade. Encouragement of the American merchant marine's participation in the China trade, while only a corollary of the normalization and development of that trade, would be desirable, from the realignment viewpoint, in the contacts that it would provide.

(c) Feasibility. Either the cessation of the Nationalist blockade of Chinese Communist ports or US naval escort of American-flag shipping must be assumed, if US shipping contacts are to be encouraged. Other US action would involve little more than the formality of giving such contacts official approval.

(3) Encouragement of US Airline Contacts with China.

(a) Economic consequences. Economically, US airline contacts with Communist China would be of little value in themselves as levers for realignment, although they would provide additional contacts through which to work to that end.

(b) Political consequences. US official guidance of air negotiations should weigh the advantages of US participation in the development and maintenance of China's air facilities against the disadvantages of possible additions to Chinese Communist military potential that might accrue.

Just as US airline contacts with Communist China and the American merchant marine's participation in the China trade do not, of themselves, offer levers for realignment, neither do they commit the US to a policy of realignment and the contacts provided could be of value irrespective of such a policy.

(c) Feasibility. There would be no problem in implementing a policy of encouraging US airline contacts with China.

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(4) Provision of Foreign Exchange for China.

(a) Economic consequences. Because China's foreign exchange reserves are small, and because exports and other sources of foreign exchange are expected to continue well under prewar levels, the Communists will be extremely short of dollars for many years. Any measures by which the US could increase China's earnings or supply of foreign exchange, therefore, would be of material assistance. Although short-term credits are available from such countries as the UK, Belgium, and Switzerland, the availability of long-term US Government or private credit may be vital to the success of China's future program for economic development.

(b) Political consequences. The granting of US Government credits to China at this time probably would constrain the Communists to moderate their virulent anti-US propaganda. Such a tactical shift, however, would not reflect any genuine change in the Chinese Communists' pro-Soviet and anti-US orientation. Indeed, the extension of US credits to China in the immediate future might serve to reinforce Sino-Soviet "friendship," since such action would lessen the economic difficulties which threaten that friendship. If the Chinese Communists were constantly tantalized by the possibility of obtaining US credits, however, such a prospect -- combined with disillusion over the unavailability of Soviet credits -- might constitute a significant pressure for realignment at some future date.

(c) Feasibility. US dollar exchange could be made available to China by two methods. The first is the extension of public and/or private credit. While the US could extend official credits to China, if this were deemed to be in the national interest, extension of private long-term credits to China would depend on the attractiveness of investment in China as well as the extent to which the US would underwrite such investment.

The second measure whereby the US could assist China in building up foreign exchange holdings would be the easing of tariff administration on Chinese imports. At present no unduly harsh administrative controls are imposed by the US on imports from China. However, any discriminatory device that might be imposed in the implementation of a harsh economic policy (e.g. overvaluation of imports for duty assessment) could, of course, be eased at any time, in the event of an over-all shift in the US approach to the Chinese Communists.

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23 December 1949

MEMORANDUM FOR HOLDERS OF IM-264

SUBJECT: Correction in IM-264

1. Holders of IM-264 are requested to make this correction on all copies:

Insert the following sentence to replace the second sentence of the second paragraph of section (2) (a) on page 4:

"In terms of current Chinese needs, controls over those commodities needed to satisfy non-deferable, continuing industrial requirements, such as cotton and petroleum, would be at least as effective as controls over non-recurring items of industrial equipment."

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